BEFORE THE

HOUSE SUBCOMMITTEE ON RAILROADS

HEARING ON THE STATUS OF THE SURFACE TRANSPORTATION BOARD AND RAILROAD ECONOMIC REGULATION

STATEMENT

OF

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Contents

I. Summary of Statement of William J. Rennicke, Managing Director, Mercer Management Consulting, Inc.

This statement has been prepared by William J. Rennicke, a Managing Director with Mercer Management Consulting, Inc. (Mercer). I have more than 30 years of experience consulting to the transportation industry and to users of transportation on a wide range of management, regulatory, economic, litigation, and asset management issues. I specialize in transportation strategic planning, management, marketing, economics, and operations, and have particular expertise in restructuring, organizational redesign, and transactions to improve financial and operating performance of transport operators around the world. I have previously provided expert testimony on the state of the North American rail industry on several occasions before the Congress and the Canadian Parliament. I have also directed the analysis of the competitive effects of transactions before the Federal Trade Commission and the Department of Justice.

My purpose in preparing this statement is to provide the Committee with Mercer's perspective on the state of the railroad industry, including its current financial conditions and transformation since enactment of the Staggers Rail Act of 1980, issues and challenges facing the industry and long-term capital funding needs. My testimony is based on experience working with many of the largest North American railroads as well as with their suppliers and customers.

I would like to make a number of points before the Committee today. Several of these points are updates of testimony Mercer provided the Senate in 2001 and to the House in 1999. In making these points, I will refer to the supporting visual materials in Section II of the document before you.

1. **Deregulation continues to stimulate an efficient and competitive rail industry and has benefited shippers, consumers, and the economy as a whole.**

   - Since the implementation of the Staggers Act in 1980, U.S. railways have become more competitive, innovative, and efficient.

   - Trends in the operating ratios of the US Class I railroads remain positive; volume has been growing strongly; and rail productivity has improved substantially in the almost two and a half decades following deregulation.

   - Average revenues per ton-mile for major commodities in which railroads have a high market share have been flat or declining through the 1990s and into the current decade.

   - Most of productivity gained through deregulation has been shared with customers in the form of rate reductions.

   - By increasing the efficiency and reliability of railroads, deregulation has driven down the cost to the economy of moving and managing goods.

   - The cost, productivity, and freight rates per ton-mile of the North American railroads are the envy of freight railroads worldwide.

2. **Despite significant productivity and service improvements made during the past two and a half decades, the industry faces many challenges.**

   - Rates of productivity improvement are slowing. Railroads are running out of traditional sources of productivity improvement.

   - Rate declines coupled with unit cost inflation have continued to expand a large "rate-cost" gap for the railroads. Productivity improvements have been key to closing this gap and maintaining the financial viability of the railroad industry.

   - While facing rate pressure on major bulk commodities, railroads are also being challenged by customers to improve service performance. As one might expect, the pressure for improved service comes primarily from shippers of truck-competitive merchandise traffic, but it is also coming increasingly from shippers of bulk traffic as they seek to improve the utilization of their assets and to manage their inventory costs. Continued service improvements will require higher levels of capital investment.

   - Total Class I rail capital expenditures have risen from $3.6 billion in 1990 to $5.7 billion in 2002 – an increase of approximately 56 percent in nominal terms. Even larger capital expenditures will be required, however, for capacity expansion to handle growing volumes and improve service, as well as to realize new efficiencies needed for the railroads to cope with the continuing decline in revenue per ton-mile.

   - However, investors and analysts are skeptical that railroad financial performance will support the additional capital required by the industry. Moreover, the hangover from the financial distress in the airline industry, in which many investors in aircraft lost money, and new international banking regulations are putting pressure even on traditional railroad equipment finance transactions.

3. **Railroads also are under pressure to invest in new capabilities to avoid losing customers.**

   - Railroads are compelled to keep pace with the changing supply chain needs of their customers if they are to remain competitive with other modes of transportation.

   - For example, Radio Frequency Identification, or RFID, is emerging as a major competitive factor in supply chains. RFID tags are similar to electronic barcodes and can be embedded in a shipment to provide tracking and other types of information at a distance.

   - Only a few years ago, RFID tags were virtually unknown. Within two to three years, they will be ubiquitous in supply chains.

   - Supply chain giants, including Wal-Mart and the Department of Defense, are driving the adoption of RFID.

- Wal-Mart is requiring its 100 largest suppliers to include RFID tags in all pallets by January 2005. By January 2006, all 10,000-plus Wal-Mart suppliers will have to add RFID tags at the case level. Researchers at Bear Stearns estimate that Wal-Mart's top 125 suppliers will spend $500M complying with the RFID mandate.

- The Dept. of Defense is requiring its 43,000 suppliers to put RFID tags on pallets, cases, and certain individual items by January 2005.

- In the near future, railroads' customers will demand 100 percent visibility over their goods in transit. The transportation providers that can provide this capability quickly and efficiently through RFID or other technologies will be competitively advantaged.

- Railroads already have invested heavily in RFID to track their own railcars and mobile assets. However, they may have to invest millions of dollars more collectively in the technology – readers, antennae, communications networks, and specialized software – needed to make this location information available to customers in useful form.

- Because of their larger size and the fixed nature of their networks, railroads may be able to mount a stronger response to the RFID challenge than competing trucking carriers. Responses could include an industrywide "pool" to deliver ubiquitous RFID capabilities, potentially with the aid of third-party service providers, integrators, and investors.

4. **Creative commercial alliances between railroads, suppliers and third parties continue to be needed to fuel additional substantive productivity gains for the railroads.**

- With historical drivers of productivity improvement substantially diminished, railroads are likely to turn to extended business partnerships and strategic alliances (short of merger) in order to create new value.

- By "unbundling" the rail value chain, railroads are identifying partner companies that may be more efficient providers of distinct services or more appropriate owners of distinct assets.

- Alliances can and are being formed between a railroad and another railroad; directly between a railroad and a third party (such as a supplier); or between a railroad and an intermediary (such as a financial investor).

- Because direct railroad-to-railroad collaboration can be difficult to execute, indirect collaboration through intermediaries (either traditional or new Internet-based intermediaries) is likely to be easier but may require new and creative transactions with suppliers and financial institutions.

- Railroads are now looking to suppliers for innovative ways to ease capital investment levels and increase productivity. To capture these opportunities, suppliers along with financial institutions have to take larger stakes in the rail value chain and develop closer working relationships with railroads.

5. **Given the railroads' continuing challenges, a stable regulatory environment is required to ensure the health of the industry and the continued flow of private capital.**

   - In the current skittish capital markets, any substantial shift in regulatory policy will add an expensive level of uncertainty in the investment process.
   - An example of such regulatory uncertainty is the current discussion of providing a different standard for regulatory review of "small shipper" rates, which proponents would extend to cover small shipments made by very large companies.
   - As the exhibits I have provided to the Committee show, while a simplistic analysis of rates would seem to indicate that there are large disparities in rates for similar shipments, most such disparities actually are explained by differences in the characteristics of the specific shipments. An analysis Mercer conducted on a traffic sample several years ago found no pattern of rate discrimination against small shippers.
   - Many of us with experience in the railroad industry began our careers sorting through the wreckage that pervasive regulation of the railroad industry had created. The markets remember why the Staggers Act was necessary, and will be wary of actions – such as the "small shipper" proposal – that could reimpose regulation over large portions of the railroads' marketplace.

6. **New international banking regulations and policy will place railroad investments under an increasing level of credit and risk review and could increase the cost of funds.**

   - New international regulations and policy in the financial sector as well as the high default rate on transportation equipment over the last four years could increase the cost of funds for critical railroad equipment

   – Historically during strong economic periods the valuation process for all types of transportation equipment relied heavily on appraisal and the trailing performance of the asset type. For the last 24 months, however, the high default and writedown rate for aviation assets has created a challenge for the whole range of parties that provide rail rolling stock.

   - The tightening of credit and evaluation comes at a time when the rail equipment sector is trying to pull out of one of the most severe downturns in its history, and the users of rail equipment are scrambling to arrange capacity for areas where car shortages are undercutting the customer's ability to ship and are driving business away from the railroads.

- The international Basel II Accords are establishing new procedures for evaluating the risk on railroad equipment and beginning to impact the ability of parties who are trying to finance rail equipment at attractive cost of funds.
  - In August 2003, to ensure that leading US banks comply with Basel II, the four US bank and thrift regulators jointly issued two consultation documents on the implementation of the new Basel Capital Accord (Basel II).[1]
- Most of the regulatory pressure to improve the way banks approach risk and capital has arisen from concerns over commercial lending risks. Basel II will most affect capital attribution within banks by encouraging banks to attribute capital in a much more risk-sensitive manner than most do at present.
  - The capital attributed to individual business units is insufficiently risk-sensitive at many banks today. Basel II represents a significant improvement in the risk sensitivity of capital regulation and is better aligned with best practice economic capital models. This should provide an incentive for banks to revisit their internal capital attribution assumptions.[2]
- We do not expect Basel II to have a revolutionary impact on the overall banking industry. Most banks operate with capital levels well in excess of regulatory minimums, due to rating agency and market pressures. As banks prepare for implementing Basel II, however, practices and procedures for evaluating the risk associated with all types of investment are being reviewed.
- The requirements to demonstrate the level of risk for railcars has already led in some cases to more complex and less successful funding.
- Mercer believes that many of the issues being raised in the capital markets can be addressed if the focus of credit and risk analyses moves to some of the more rigorous quantitative techniques that have been used for the last 20 or so years by financial institutions that have not accepted appraisals or trailing performance as a factor for future results.
  - Cash flow estimates that project the financial performance of the assets subject to the transaction is one approach that simultaneously addresses the requirements of the Basel II Accords and the credit deficiencies of the last 48 months.
- We believe that the voluntary adoption of the quantitative risk and credit practices will restore the financial sectors understanding of the investment in rail equipment and restore the required capital needed to fund the assets.

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[1] *Advance Notice of Proposed Rulemaking*, joint release from the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, 4 August 2003.

[2] *Risk and Basel II: A retail perspective*, Mercer Oliver Wyman, December 2003.